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No. 90-516

Supreme Court, U.S.  
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In The  
Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

*Petitioner,*

v.

KEMPER FINANCIAL SERVICES, INC., and  
CASH EQUIVALENT FUND, INC.,

*Respondents.*

On Writ Of Certiorari To The United States Court Of  
Appeals For The Seventh Circuit

BRIEF FOR PETITIONER

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**QUESTION PRESENTED FOR REVIEW**

As a prerequisite to bringing a shareholder action on behalf of an investment company to recover damages for proxy fraud under Section 20 of the Investment Company Act, must the shareholder first make a demand upon the company's directors to bring the action even where such a demand would be futile?

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## OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit is reported at 908 F.2d 1338. The opinion of the District Court for the Northern District of Illinois is reported at 659 F. Supp. 1153 (February 2, 1987). The final judgment of the District Court was entered September 1, 1989.

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 JURISDICTION

The judgment of the Court of Appeals was entered on July 18, 1990. A Petition for Writ of Certiorari was filed on September 24, 1990 and granted, as to the question presented for review, demand futility, on December 3, 1990. Certiorari was denied on the second question, the right to jury trial. (A cross-petition, filed on October 19, 1990, was also denied on December 3, 1990). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

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 STATUTE AND RULE INVOLVED

Section 20(a) of the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-20(a), is set forth at 96a.<sup>1</sup> Rule 23.1 of the Federal Rules of Civil Procedure is set forth at 99a-100a. SEC Rules 20a-1(a) and 20a-2(b)(4), 17 CFR §§ 270.20a-1(a) and 270.20a-2(b)(4) provide as follows:

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<sup>1</sup> “\_\_a” refers to the Appendix to the Petition for Certiorari. “J.A. \_\_” refers to the Joint Appendix.

**Rule 20a-1. Solicitation of Proxies, Consents and Authorizations.**

(a) No person shall solicit or permit the use of his name to solicit any proxy, consent or authorization in respect of any security of which a registered investment company is the issuer, except upon compliance with Rules 20a-2 and 20a-3 and all rules and regulations adopted pursuant to Section 14(a) of the Securities Exchange Act of 1934 that would be applicable to such solicitation if it were made in respect of a security registered on a national securities exchange. Unless the solicitation is made in respect of a security registered on a national securities exchange, none of the soliciting material need be filed with such exchange.

\* \* \*

**Rule 20a-2. Information Pertaining to Investment Adviser and Investment Advisory Contracts.**

\* \* \*

(b) If action is to be taken with respect to an investment advisory contract, the following information shall be included in the proxy statement:

\* \* \*

(4) If the investment adviser acts as such with respect to any other investment company, identify and state the size of each such other company and state the rate of the investment adviser's compensation.

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**STATEMENT OF THE CASE**

Petitioner is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund"), an open-end investment company or mutual fund registered under the Investment

Company Act of 1940. She has brought the action on behalf of the Fund against Kemper Financial Services, Inc., its investment adviser (the "Adviser").<sup>2</sup>

The action is brought under Sections 20(a) and 36(b) of the Investment Company Act. Section 20(a) proscribes the fraudulent solicitation of proxies with respect to a registered investment company. The complaint herein alleges that the defendant distributed a false and misleading proxy statement which misrepresented comparative fee rates in order to obtain shareholder approval of its agreement with the Fund. The plaintiff complains that the Adviser provides substantially the same services for a sister fund and charges the sister fund significantly less, whereas the proxy statement gives the false impression that the fee rates paid by the sister fund are as high or higher than those paid by the Fund. 89a-91a. The complaint seeks the payment of damages to the Fund resulting from the fraud. 93a.

Section 36(b), which mandates a fiduciary duty with respect to the receipt of compensation, is not implicated in the instant proceeding.

Plaintiff made no pre-suit demand upon the directors to institute or prosecute the action. The complaint sets forth the reasons for not making such a demand. Those reasons are as follows:

(a) With respect to the claims asserted under Section 36(b) of the Act, no such demand is required.

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<sup>2</sup> *Kamen v. Kemper Financial Services, Inc.*, No. 85 C 4587 (N.D. Ill.). Jurisdiction of the District Court was invoked under Sections 36(b) and 44 of the Act, 15 U.S.C. Sections 80a-35(b) and 43, respectively.

(b) The "interested" directors have a personal financial interest adverse to the successful prosecution of the lawsuit, and the so-called "non-interested" directors are beholden to the Adviser; they receive aggregate remuneration of approximately \$300,000 a year as directors of the Fund and other Funds managed by the Adviser.

(c) All of the directors voted to distribute the false proxy statement so that any suit brought to establish liability for the falsity of the statement would establish their own culpability and liability.

(d) The directors caused the Fund to oppose the action on substantive grounds.

In addition, the complaint alleges that the directors are under the control of the Adviser and that application of a demand requirement would be inconsistent with the federal policy underlying Section 20 of the Investment Company Act. 92a-93a. In deposition testimony, the directors testified that they would not institute this action. J.A. 70-85. In short, as alleged in the complaint, making a demand on the Fund or its directors to institute or prosecute this action would be futile.

Defendants moved to dismiss plaintiff's claim of proxy fraud, and the District Court granted the motion on the ground that plaintiff had failed to justify the absence of demand upon the Fund directors to institute suit to recover for that claim. 33a, 46a-56a. Thereafter, the District Court dismissed the Section 36(b) claim, giving rise to a final judgment. 84a.

Upon appeal, the Court of Appeals reinstated the Section 36(b) claim, but affirmed the dismissal of the

proxy fraud claim, holding that demand on directors must be made even if it be futile.<sup>3</sup> 1a-32a.

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## SUMMARY OF ARGUMENT

The Court of Appeals' holding that demand must be made even if futile is contrary to long established legal principles and to the dictates of common sense. The holding below violates both state and federal law, is inconsistent with the public policy underlying the proxy fraud provisions of the Investment Company Act, and, if permitted to stand, would spell the demise of shareholder derivative actions which have been the most effective remedy against management overreaching.

Shareholder demand in the instant case is clearly futile and unwarranted. The directors are the very perpetrators of the proxy fraud complained of. They have voiced their opposition to the suit both in deposition testimony and by causing the Fund to oppose the action on the merits. Both the management directors and the so-called non-interested directors benefitted from the fraud, the former through higher fee payments and the latter through sizable emoluments derived from their office. Under these circumstances, requiring a demand would result in the destruction of a meritorious action.

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<sup>3</sup> Both the District Court and the Court of Appeals held that plaintiff was not entitled to a jury trial under Section 36(b). Because both courts held that the proxy fraud claim would not lie, neither court considered whether plaintiff is entitled to a jury trial thereunder.

## ARGUMENT

### I.

#### DEMAND ON DIRECTORS IS EXCUSED WHEN IT WOULD BE FUTILE

Although orderly presentation would normally call for our discussion to begin with an inquiry into the question of what law applies, the uniformity of judicial decisions and the egregiousness of the Court of Appeals' error prompts petitioner to begin with a brief discussion of the substantive issue involved.

To begin with, Rule 23.1 of the Federal Rules of Civil Procedure, which is a distillation of this Court's holdings<sup>4</sup>, acknowledges the existence of exceptions to the demand requirement by permitting the plaintiff to allege the reasons for not making a demand. This Court held in *Smith v. Sperling*, 354 U.S. 91, 94 and n.2 (1957), that demand futility is just such an exception. Futility of demand satisfies the requirements of the rule. *Accord*: *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984); *Delaware & Hudson Co. v. Albany & Susquehanna R. Co.*, 213 U.S. 435 (1909); *Doctor v. Harrington*, 196 U.S. 579 (1905)<sup>5</sup>; *Hawes v. Oakland*, 104 U.S. 450 (1881).

Following the holdings of this Court, the vast majority of Circuits – indeed, every Circuit Court of Appeals which has ruled upon the issue – has held that demand is excused where it would be futile. Illustrative of the cases

<sup>4</sup> *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 n.5 (1984).

<sup>5</sup> The Court of Appeals' attempts to distinguish *Fox*, *Delaware & Hudson* and *Doctor* will not withstand analysis. See pp. 6-8 of the Petition for Certiorari.

are the following: *Gaubert v. Federal Home Loan Bank Board*, 863 F.2d 59 (D.C. Cir. 1988); *Untermeyer v. Fidelity Daily Income Trust*, 580 F.2d 22 (1st Cir. 1978); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Lewis v. Curtis*, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); *Meltzer v. Atlantic Research Corp.*, 330 F.2d 946 (4th Cir.), *cert. denied, sub nom.*, *Scurlock v. Meltzer*, 379 U.S. 841 (1964); *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981); *Allright Missouri, Inc. v. Billeter*, 829 F.2d 631 (8th Cir. 1987); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir. 1980). In addition, District Courts in the Sixth, Tenth and Eleventh Circuits have similarly held: *Granada Investments, Inc. v. DWG Corp.*, 717 F. Supp. 533 (N.D. Ohio 1989); *Mullen v. Sweetwater Development Corp.*, 619 F. Supp. 809 (D.C. Colo. 1985); *First American Bank and Trust v. Frogel*, 726 F. Supp. 1292 (S.D. Fla. 1989). And prior decisions of the Court of Appeals for the Seventh Circuit also held that demand is excused where futile: *Thornton v. Evans*, 692 F.2d 1064 (7th Cir. 1982); *Nussbacher v. Continental Illinois National Bank*, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976).

In addition, virtually every state court passing upon the issue has also held that futility excuses demand. See 13 Fletcher, *Cyclopedia of the Law of Private Corporations* § 5965 and cases cited at note 1 thereof (1984 Rev. Volume and 1990 Cum. Supp.).

The court below did not cite any authority for its unique holding that futility does not excuse demand. It did lean heavily on the American Law Institute Tentative Draft, *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03 (Tentative Draft No. 8, 1988). 13a,

14a, 15a, 16a. However, the Tentative Draft is clear on the existing state of the law. The very section cited by the Court of Appeals states, "Under prevailing law, demand on the board is required as a pre-condition to maintaining a derivative suit, unless such demand would be futile." (Tentative Draft, p. 64).

## II.

### WELL PLEADED FEDERAL PROXY FRAUD CLAIMS ARE NOT SUBJECT TO SUMMARY DISMISSAL UNDER STATE LAW

*Burks v. Lasker*, 441 U.S. 471 (1979), appears to be the starting point for determination of which law is applicable. *Burks v. Lasker* dealt with the question of whether disinterested directors of an investment company may terminate a shareholder's derivative suit brought against other directors under the Investment Company Act and the Investment Advisers Act. This Court held that "Federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the ICA and IAA." 441 U.S. at 486.

Although the question of directorial termination is closely related to the question of demand, this Court has indicated that *Burks v. Lasker* is not necessarily determinative in the latter situation. In *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 532 n.8 (1984), the Court specifically referred to *Burks v. Lasker* and the holding therein that the substantive law of the state of incorporation applies to directorial termination. The Court continued, however, as follows:

Because we conclude that a suit brought under § 36(b) of the ICA is not a "derivative action" for purposes of Rule 23.1, see *infra*, at 842, we need not decide whether the Rule itself, as a matter of federal procedure, makes demand on directors the predicate to a proper derivative suit in federal courts or whether any such obligation must instead be found in applicable substantive law.

*Burks v. Lasker* did not involve proxy fraud. SEC Rule 20a-2(b)(4) requires a proxy statement submitted in connection with a shareholder vote on an investment advisory contract to identify other investment companies for which the adviser acts and to state the rate of advisory compensation charged to such other companies. The manifest purpose of the regulation is to give the shareholders a basis for comparison. Here, however, the shareholders were led to believe by a false proxy statement that a sister fund was being charged as much or more than the Fund, whereas in fact the sister fund was charged considerably less. The difference amounted to \$10,000,000 per year. 86a, 90a. The shareholders' approval of the advisory fees benefitted both the respondent, which was the direct recipient thereof, and the "non-interested" directors, whose sizable emoluments depended upon respondent's grace. 92a.

In *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980), a case subsequent to *Burks v. Lasker* but preceding *Fox*, the Court of Appeals for the Second Circuit, relying upon this Court's seminal decision in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), held that claims under the proxy laws were not subject to dismissal under the business judgment rule. Referring to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), the Court concluded (615 F.2d at 64):

In short, we conclude that to the extent that a complaint states claims against directors under § 14(a) upon which relief may be granted, federal policy prevents the summary dismissal of those claims pursuant to the business judgment of those defendant directors.

The conclusion that well pleaded § 14(a) claims against directors are not subject to summary dismissal on the basis of their exercise of business judgment makes unnecessary further study of what powers Ohio law would grant with respect to the § 14(a) claims.

Although in the present case the directors are not themselves defendants, they are the ones who distributed the proxy statement and are, therefore, directly responsible for the violation. 92a-93a. As the complaint alleges, the action, if successful, would establish their culpability. Just as a plaintiff may not bootstrap his futility assertions by naming innocent directors as defendants, *Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983), by the same token, petitioner Kamen's choice not to name the directors in the first instance does not establish their impartiality. *Lewis v. Curtis*, 671 F.2d 779, 786-7 (3d Cir. 1982), *cert. denied*, 459 U.S. 880. Accordingly, under *Galef*, state law cannot justify dismissal of the present action.

While *Galef* relied upon the strong public policy declarations in *Borak* ("Private enforcement of the proxy rules provides a necessary supplement to commission action. [377 U.S. at 432]<sup>6</sup> . . . the overriding federal law applicable here would, where the facts required, control

<sup>6</sup> This policy was expressly and strongly reaffirmed in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985).

the appropriateness of redress despite the provisions of state corporation law . . . " 377 U.S. at 434), other cases dealing with directorial terminations of actions involving asserted false proxy statements have applied state law. E.g., *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980). This brief will discuss both federal and Maryland law.

### III.

#### UNDER MARYLAND LAW, DEMAND IS EXCUSED

In the present case, the Fund was a Maryland corporation when the action was commenced. 9a. The leading Maryland case is *Parish v. Maryland & Virginia Milk Producers Association*, 250 Md. 24, 242 A.2d 512 (1968), *cert. denied*, 404 U.S. 940 (1971). That case held that where the directors were involved in the wrongdoing, as they were here by sending out the false proxy statement, demand upon them to bring the action is properly excused. *Parish* also held that demand was excused because the directors affirmed their support of management's action after the commencement of the law suit. 242 A.2d at 546-47.

To similar effect in applying Maryland law is *Rosengarten v. Buckley*, 565 F. Supp. 193, 197-8 (D. Md. 1982), which holds that under Maryland law, fraud, such as the proxy fraud involved here, vitiates the demand requirement. See also *Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984), citing *Eisler v. Eastern States Corp.*, 182 Md. 329, 333 (1943), and *Oldfield v. Alston*, 77 F.R.D. 735 (N.D. Ga. 1978). In the last cited case, the Court, applying Maryland law, concluded (77 F.R.D. at 740):

Accordingly, given plaintiff's allegations that all of the trustees either actively participated in the wrongful transactions or, at the least, approved or ratified such transactions with knowledge or notice of their illegality, the court concludes that demand upon the trustees to bring this action should be excused.

... the conduct of the unaffiliated trustees in this action, which conclusively demonstrates their antagonism to it. ANRET's answer did not take a neutral position. Nor did ANRET merely oppose this action on the basis of lack of demand on the trustees or its shareholders. Rather, ANRET has vigorously opposed this action on the merits. In this regard, there is also authority that a demand upon directors or trustees is unnecessary where the derivative entity contests the action on the merits. *See, e.g., Meltzer v. Atlantic Research Corp.*, 330 F.2d 946, 948 (4th Cir.), *cert. denied sub nom., Scurlock v. Meltzer*, 379 U.S. 841, 85 S.Ct. 78, 13 L.Ed.2d 47 (1964).

As in *Oldfield*, the directors in the present case have caused the corporation to oppose the action on the merits. 93a; J.A. 2, 4, 6, 7, 24-25, 62, 65-66. In deposition testimony, their hostility to the action is manifest. J.A. 70-85. In short, under Maryland law, demand is clearly excused in the circumstances prevailing here.

The Court of Appeals refused to apply Maryland law because petitioner's urging of Maryland law was not made until the reply brief. Citing *Wilson v. O'Leary*, 895 F.2d 378, 384 (7th Cir. 1990), the Court held that the argument as to the application of Maryland law came too late. 9a. However, *O'Leary* was a criminal case in which the prosecution sought to argue for the first time in its

reply brief on appeal that an error in admitting an involuntary confession was harmless. As the Court stated, the reason for the requirement that arguments for reversal be made in the opening brief is "so that the appellee may address them." 895 F.2d at 384. In the present case, however, petitioner's reply brief in the Court of Appeals was filed on December 19, 1989. J.A. 2. Oral argument was not held until May 11, 1990 (J.A. 3), after an application by respondent for an adjournment of the date from April 12, 1990. In short, the respondent had ample time and opportunity to address petitioner's arguments as to Maryland law. The rigid application of a rule designed for the protection of criminal defendants should not operate to prevent the appropriate consideration of applicable law in the present circumstances, particularly in view of the fact that the court below adopted a rule of law not urged by any party prior to its decision. Moreover, in opposing certiorari, respondent discussed Maryland law. Respondent did not suggest that consideration of Maryland law was barred because of lateness, and thus, under Rule 15.1 of this Court, waived any such contention.

#### IV.

#### DEMAND IS EXCUSED UNDER FEDERAL LAW

As discussed under Point I, *supra*, the holding of the Court of Appeals that demand must be made even if futile is a conscious defiance of this court's prior holdings, as well as of the holdings of every federal court which has considered the question. One might assume that no court, much less a federal court of appeals, would issue such a doctrinaire opinion if it could reach the same result by a less revolutionary route. In this case the less

rebellious path would have been to rule that demand would not have been futile. But the postulated assumption is correct; such a finding would not be supportable.

What are the ingredients of futility? Obviously, a corporation's business is supposed to be run by its directors, and they are the first resort of policy decisions such as instituting litigation. But clearly there are considerations which lead to exceptions. *Hawes v. Oakland*, 104 U.S. 450 (1881), was the first<sup>7</sup> attempt to delineate the underlying considerations, but the Court there said little more than that the complaining shareholder should state with particularity why it was not reasonable to require him to exhaust his intra-corporate remedies. *Doctor v. Harrington*, 196 U.S. 579 (1905), set forth one example of futility. The Court there held that an allegation that the board of directors was controlled and dominated by the majority shareholder, whose self-dealing was attacked in the complaint, was sufficient to justify maintenance of a stockholder suit. *Delaware & Hudson Co. v. Albany & Susquehanna R. Co.*, 213 U.S. 435 (1909), extended the futility exception to a case involving interlocking directors, where, absent the majority control present in *Doctor*, there

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<sup>7</sup> In *Dodge v. Woolsey*, 18 How. (59 U.S.) 331 (1855), a demand had been made upon the directors to sue to prevent the collection of a tax. The directors refused because they believed litigation would be cumbersome. The Court noted that "... the refusal ... was a non-performance of a confessed official obligation, amounting to what the law considers a breach of trust, though it may not involve intentional moral delinquency." 18 How. at 345. The Court held that the shareholders could properly sue on behalf of the corporation: "... the powers of a court of equity may be put in motion at the instance of a single shareholder ...". 18 How. at 343.

was "practically efficient" control. 213 U.S. at 452. The Court held that demand was excused, stating (213 U.S. at 451):

The company whose interest it was to assert the right to payment and to demand it was under the control or could be influenced by the company whose interest it was to deny indebtedness and resist payment. And though there are allegations in the bill of contrary import, the good faith of the directors need not be questioned. They might, notwithstanding, be firm in their views, — firm to resist appeals against them. Their views seemed to persist through many years. At any rate, a situation was presented fully as formidable to the interest of stockholders in the Susquehanna Company as that presented in the Harrington Case. And it may be well doubted whether the directors of the Susquehanna Company, so being directors of the Delaware Company, and who, either from an apathy that endured through many years, could discern no right in that company to assert, or, through conviction of the absence of right, were the best agents to begin or conduct a litigation of such right. It was certainly natural enough that a stockholder should seek more earnest representatives, and consider that the directors "occupied," to use the language of *Dodge v. Woolsey*, "antagonistic grounds in respect to the controversy" as to him. The attitude of the directors need not be sinister. It may be sincere. It was so in *Chicago v. Mills*, 204 U.S. 321, 51 L.ed. 504, 27 Sup.Ct. Rep. 286, and *Ex Parte Young*, 209 U.S. 123, 52 L.ed. 714, 13 L.R.A.(N.S.) 932, 28 Sup.Ct. Rep. 441, and other cases. In this case it was certainly determined. It continued until after this suit was brought. Both the Delaware Company and the Susquehanna Company, then under "the administration of the Delaware

Company," to quote from the circuit court of appeals, demurred to the bill.

In *Smith v. Sperling*, 354 U.S. 91 (1957), the Court expanded somewhat upon the definition of futility (354 U.S. at 96-97):

It seems to us that the proper course is not to try out the issues presented by the charges of wrongdoing but to determine the issue of antagonism on the face of the pleadings and by the nature of the controversy. The bill and answer normally determine whether the management is antagonistic to the stockholders, as *Central R. Co. of New Jersey v. Mills*, 113 U.S. 249, 5 S.Ct. 456, 28 L.Ed. 949, and *Doctor v. Harrington*, *supra*, indicate. The management may refuse or fail to act for any number of reasons. Fraud may be one; the reluctance to take action against a close business associate may be another; honest belief in the wisdom of the course of action which the management has approved may be still another; and so on. As the Court said in *Delaware & Hudson Co. v. Albany & S.R. Co.*, 213 U.S. 435, 451, 29 S.Ct. 540, 545, 53 L.Ed. 862, where the management was deemed to be antagonistic to the stockholder, "The attitude of the directors need not be sinister. It may be sincere." Whenever the management refuses to take action to undo a business transaction or whenever, as in this case, it so solidly approves it that any demand to rescind would be futile, antagonism is evident.

(footnote omitted). Justice Frankfurter, dissenting from the jurisdictional holding, agreed that "sincere opposition by directors would make such a demand [on the directors] futile" for purposes of compliance with Rule 94 (now Rule 23.1). 354 U.S. 99, 110 (1957). Justices Burton,

Harlan and Whittaker joined in Justice Frankfurter's opinion. The Court was, thus, unanimous on this point.<sup>8</sup>

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<sup>8</sup> In accordance with the decisions of this Court, the Seventh Circuit had earlier held that board opposition, including post-litem board opposition, is sufficient to excuse demand. In *Nussbacher v. Continental Illinois National B&T Co.*, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976), the court held that the post litigative decision by directors not to initiate action was sufficient to demonstrate the futility of demand. The court stated (at 878-79):

Turning then to the issue which is before us, we are satisfied that there was sufficient before the district court to preclude it in the exercise of proper discretion from dismissing the case on the 23.1 ground. Upon analysis, it appears to us that Continental is contending in effect that demand had to be made. This position would make the alternative prong of Rule 23.1 which permits the plaintiff to explain why he made no demand about as meaningless as it would have been for plaintiff to have made a demand in the present case. Not only did the board of directors adopt the position at a meeting that they would not have initiated the New York action, identical in practically all respects to the suit filed in Illinois, but the affidavit of the board chairman which was before the district court concluded by referring to "the determination of the Board of Directors of Leasco Corporation that [the Illinois action] maintained by Plaintiff Nussbacher is inconsistent with the best interests of the Corporation." This decision and determination may well be proved to have been a sound evaluation when the merits questions are reached in this litigation; suffice it to say, the message is loud and clear that under no circumstances would the board of directors have approved the corporation bringing the action.

Dealing with another portion of Rule 23.1 (then Rule 23(b)), this Court said in *Surowitz v. Hilton Hotels Corporation*, 383 U.S. 363, 371, 373 (1966), "Rule 23(b) was not written in order to bar derivative suits. . . . We cannot construe Rule 23 or any other one of the Federal Rules as compelling courts to summarily dismiss, without any answer or argument at all, cases like this where grave charges of fraud are shown by the record to be based on reasonable beliefs growing out of careful investigation. The basic purpose of the Federal Rules is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits. Rule 23(b), like the other civil rules, was written to further, not defeat the ends of justice."

In the present case the record establishes the futility of demand. The case should proceed to an adjudication on the merits.

## V.

### REQUIRING DEMAND WHERE FUTILE POSES VIRTUALLY INSUPERABLE OBSTACLES TO THE ENFORCEMENT OF FEDERAL RIGHTS WITHOUT CONCOMITANT BENEFITS

The Court below engaged in a quasi-functional analysis of the law of demand, purporting to balance benefits

and burdens. Petitioner submits that the discipline of legal scholarship should govern the determination of cases and controversies. Nevertheless, if a functional analysis is applied, the conclusion to which one is compelled is that requiring demand even where futile results in the imposition of tremendous impediments to the enforcement of the securities laws, with the concomitant loss of investor protection which those laws are designed to achieve, while at the same time reducing rather than improving managerial efficiency.

The keystone of the analysis of the Court of Appeals is that the making of a demand is a "cheap and quick expedient", 15a, to which corporate directors will promptly and openly respond. The court below says "let the investor make [a demand]; if indeed futile, the board's response will establish that soon enough." 15a. "If demand is futile in fact for any of these reasons, then the board will say no with dispatch and the case may proceed." 17a. This naive hypothesis of the reaction of corporate directors accused of wrongdoing is totally at odds with reality. The court below admits that in those jurisdictions most insistent upon demand, notably Delaware, "tendering a demand to the board puts the plaintiff out of court". 12a.<sup>9</sup> It does so both procedurally - by

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<sup>9</sup> *Kaplan v. Wyatt*, 484 A.2d 501 (Del.Ch. 1984), *aff'd*, 499 A.2d 1184 (1985), is illustrative not only of the obstacles confronting the plaintiff, but also of the burdens imposed upon the litigants and the judicial system when a demand is insisted upon. In that case, following the commencement of the litigation, the corporation on whose behalf it was brought proceeded to appoint a special litigation committee to investigate

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turning over litigation to special litigation committees – and substantively, by altering the applicable standard of conduct and the focus of its judgment.

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and make a recommendation as to the complaint and its allegations. The committee hired special counsel who consumed three years with their investigation for which they billed the corporation \$500,000. In the meantime, the plaintiff's discovery was limited to inquiries into the good faith and independence of the committee without inquiring into the merits of the litigation. The chancellor, who felt compelled to follow this procedure by the decision of the Delaware Supreme Court in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (1981), nevertheless voiced his misgivings with the entire procedure as follows:

[I]t must be kept in mind that the entire procedure is designed to provide a means, if warranted, to throw a derivative plaintiff out of Court before he has an opportunity to engage in any discovery whatever in support of the merits of his cause of action purportedly brought on the corporation's behalf. In fact, the *Zapata* procedure takes the case away from the plaintiff, turns his allegations over to special agents appointed on behalf of the corporation for the purpose of making an informal, internal investigation of his charges, and places the plaintiff on the defensive once a motion to dismiss is filed by the Special Litigation Committee, leaving him to snipe away at the bona fides of the Committee and its extra-judicial investigation in a last-ditch effort to salvage a right to present the case on the corporation's behalf as he sees it. The procedure also asks the Court to consider dismissing the case prior to the time that the facts pertaining to the plaintiff's allegations are developed in an adversarial context unlike the procedure that has existed heretofore.

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The court below asserts that insistence upon a demand requirement will "not affect the standard with which the court will assess the board's decision not to sue." 13a. But, of course, it will, as the court itself admits (16a): "A decision not to file a weak lawsuit would be protected by the business judgment rule . . .". In short, what the Court of Appeals is advocating is that cases involving self-dealing (*i.e.*, virtually all derivative cases), which require the imposition of fiduciary duty standards, be transformed into cases invoking the business judgment rule. Under the latter, conduct (presumed to be disinterested) cannot be attacked unless it be such that no reasonable business person would engage in it. On the other hand, a fiduciary involved in self-dealing has the burden of proving the intrinsic fairness of his dealings with the corporation. Moreover, the conduct upon which the judgment is focused becomes not the underlying wrongdoing – in this case the proxy fraud – but the inevitable decision not to press suit.

Little wonder is it then that commentators, including those relied upon by the court below, regard insistence upon demand, even where futile, as the death of the

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As to whether this new departure in derivative litigation is good or bad I offer no judgment. . . . However, it is fraught with practical complications at the trial court level. It certainly does not speed up the course of derivative litigation and, based upon what I have seen so far, it is doubtful that it reduces the expense or inconvenience of derivative litigation to the corporation.

484 A.2d at 509-10.

derivative action; DeMott, *Shareholder Derivative Actions—Law and Practice*, § 5:03, p. 31 (1987): "... a derivative suit will not likely last long if the plaintiff files it after making a demand . . .". Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 Nw. U. L. Rev. 96, 109 (1980):

The special litigation committee cases may presage the demise of the derivative suit. When faced with a derivative suit, defendant directors will invariably request an investigation and decision by some fellow directors as to whether the suit is in the best interests of the corporation. The defendants have nothing to lose in so doing — at worst, the nonimplicated directors will decide to take over the suit, or to take a neutral stance toward the suit, leaving the defendants not worse off than when they started. More important, the prospect of such a decision is minimal; almost invariably, the directors charged with the decision decide to oppose the suit. In most cases, this opposition will result in dismissal of the suit unless the deciding directors are shown to be directly implicated in the alleged wrong or are so clumsy as to be found to have acted in bad faith. Such opposition can even block plaintiff's discovery as to defendants' alleged misdeeds.

(Footnotes omitted).

The decision of the Court below actively seeks to promote such a result by noting that, even when the action involves suit against some of the board of directors, "the board may appoint a minority of disinterested members to evaluate the demand and act for the corporation. In the extreme case in which all members are implicated, the board may expand its size and authorize the

new members to act for the firm." 15a. If this does not spell the death of all derivative actions, it certainly spells the death of derivative actions involving investment companies which, as this Court has noted, *Daily Income Fund v. Fox*, 464 U.S. 523, 538 (1984), are required to have at least 40% disinterested directors.

We began this point by noting the naivete of the Court of Appeals in assuming the ingenuous response of culpable directors in promptly and unambiguously refusing a demand. That human nature is not so pure is illustrated by the testimony of director David W. Belin in the instant case (J.A. 82-85):

I have to be candid with you and tell you I don't think the litigation has any merit, but I was aware of it.

Q. You've seen the complaint, I take it?

A. I've sign [sic] the complaint. I've seen the — there is one clause that basically says, as I remember the complaint, something about having a misleading or insufficient information in the proxy statement concerning the Kemper Money Market Fund. I happen to believe that that is specious.

But I understand that's not your opinion. That's my opinion. I've seen the complaint. With regard to — there is another portion that talks about the investment management fee being excessive. I believe and I think — I may be wrong by a few basis points, I think it's around 17 basis points or something and I think the fee is very reasonable particularly in light of the performance.

So I just really basically disagree as a representative of the independent shareholders

that there is any merit, and I think for someone to say that it's misleading - because they refer to Kemper Money Market Fund. It says it has a top rate of 50 basis points and they should have given the whole complete gradation, I just think that's utterly without merit.

Q. So that if you had been asked directly to bring an action against KFS with respect to that claim, you would have refused, is that right?

MS. HALL: Hold your answer. I'm going to advise the witness not to answer that hypothetical question.

MR. MEYER: On what basis?

MS. HALL: On the basis that it's a hypothetical question. He's here to answer - not to answer hypothetical questions.

MR. MEYER: I take it you're following counsel's advice?

(WHEREUPON, discussion was had off the record between the witness and Ms. Hall out of the hearing of other counsel and the court reporter.)

MS. HALL: I'll withdraw my objection.

BY THE WITNESS:

A. I better have the question back then.

MR. MEYER: I notice that the withdrawal of the objection comes after conference between counsel and the witness.

MS. HALL: The record will reflect that I have consulted with my client.<sup>10</sup>

<sup>10</sup> Ms. Hall represents the respondent. Mr. Belin is, purportedly, an independent director.

MR. MEYER: Would you read the question back?

(WHEREUPON, the record was read by the reporter as requested.)

BY THE WITNESS:

A. Not necessarily.

BY MR. MEYER:

Q. Are you telling me there is a chance you would have brought such an action?

A. I'm telling you that right now, I would have to give it some consideration as to whether I would or wouldn't.

Q. Well, you've had the complaint for almost two years and you've come up with the conclusion that the contention is specious.

What consideration is it that you would want to give to such a request?

A. Well, I guess if someone said it - if someone came to me as a shareholder and said that they believed there was some merit, at least I would give it some consideration.

Q. Well, you know that Jill Kamen is a shareholder, don't you?

A. I believe she is. She claims she is.

Q. And she has advanced the claim. Why is it that your reaction to the complaint would be different than your reaction to an informal communication?

A. Well, I'm telling you at least right now what my considered opinion is, and you've said if someone - your questions basically - to go back to your specific question, saying I would automatically not do something. I guess I

wouldn't automatically respond to it if that claim was brought up.

That's why I said not necessarily. I still believe that based upon at least what I perceive to be the reasonable – well, I'll call the reasonable and prudent shareholder, that this lawsuit really does not have any merit.

The premise of the decision of the Court of Appeals is, in fact, that derivative lawsuits ought to be abolished. "In the long run firms are better off when business decisions are made by business specialists, even granting the inevitable errors." Natural selection means that "Managers who make such judgment calls poorly ultimately give way to superior executives." 10a. The court below cites no empirical evidence supporting this conclusion, and, indeed, in the investment company field, the evidence is to the contrary. Both the SEC and the Congress, after extensive study, have found that investment company management is, if not impervious, at least not sensitive to competition.<sup>11</sup> Clearly even such competition as exists cannot operate effectively if corporations are permitted to deceive their shareholders with false proxy statements issued without fear of redress.

Although empirical, as opposed to intuitive, studies of the effectiveness of laws against heinous crimes may be difficult to pinpoint, one can hardly be complacent about the evisceration of an effective remedy against fraud. And that certainly is what the derivative suit is,

<sup>11</sup> S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969); Report of the SEC on the Public Policy Implications of Investment Company Growth, H. Rep. No. 2337, 89th Cong., 2d Sess. 12 (1966).

particularly in the context of proxy fraud. Professor Dent notes:

Dean Rostow has called the derivative suit "the most important procedure the law has yet developed to police the internal affairs of corporations." Rostow, *To Whom and For What Ends Is Corporate Management Responsible?*, in *The Corporation In Modern Society* 48 (E. Mason ed. 1959). Justice Jackson called it "the chief regulator of corporate management." *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949). See *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966); *Brendle v. Smith*, 46 F. Supp. 522, 525-56 (S.D.N.Y. 1942); N. Lattin, *The Law of Corporations* § 115, at 457 (2d ed. 1971) ("The derivative suit is the minority shareholders' one effective remedy against management's abuse of its trusteeship.").

Dent, *The Power of Directors To Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U. L. Rev. 96 n.3 (1980).

Congress, fully cognizant of the importance of derivative actions in enforcing the securities laws, clearly "intended to preserve the pre-existing remedy" (*Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 379 (1982)) in its frequent amendments and re-enactments of those laws and, in particular, of the Investment Company Act. The Senate Committee on Banking, Housing and Urban Affairs stated: "... [P]rivate lawsuits serve as an added deterrent to conduct made unlawful by Congress without the necessity of governmental involvement. The Committee wishes to make clear ... that such causes of action are implied under the Investment Company Act." S. Rep. No. 96-958, 96th Cong., 2d Sess. 14 (1980). See also

H. Rep. No. 96-1341, 96th Cong., 2d Sess. 29 (1980); *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982). The Court of Appeals decision, if allowed to stand, would thwart the expressed intent of Congress.

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CONCLUSION

The decision of the Court of Appeals on the question presented for review should be reversed and the case should be remanded for further proceedings.

Respectfully submitted

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